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C O N F I D E N T I A L SECTION 01 OF 03 NICOSIA 000980

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SUBJECT: "TRNC" ECONOMIC SLIDE AND THE DEUS EX MACHINA

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Classified By: AMB R. SCHLICHER FOR REASONS 1.4 (B) AND (D)

¶1. (C) Summary. The "TRNC" economy has grown at break-neck speed over the last three years, largely fueled by the boom in real estate. Overbuilding, poor finance structures and issues that have scared off foreign property buyers have turned the boom into a bust resulting in a growing liquidity shortage that has spread to the "government" itself. The risks of a major economic meltdown are low, however, because most people work in the public sector and because Turkey has indicated that it will, yet again, provide the funding needed to deal with any fiscal deficits. End Summary.

¶2. (SBU) After more than three years of stellar growth (estimated average of 13 percent/year), the economy of the "Turkish Republic of North Cyprus (TRNC)" has slowed dramatically in the second half of 2007. The director of the "State Planning Authority" (a department in the office of the "Prime Minister" responsible for compiling statistics and providing economic forecasts to the "government") told us that they anticipate GDP to decline 2-3 percent in 2007 even after achieving positive results in the first half of the year. (Note: Statistics in the "TRNC" are not very reliable, a point noted by the "State Planning" director herself, so should be considered only as indicative of trends. End Note.)

If You Build It...

¶3. (SBU) The economic boom began in 2003 in the run-up to a referendum on the reunification of island, the "Annan Plan". With prospects for a settlement in sight that would include the end of various trade barriers (lack of direct transport links, inability to join international organizations, pressure from the GoC against doing business with "TRNC" entities) faced by the "TRNC," businesses and consumers gained confidence and started investing accordingly. With land prices in the north a fraction of those in the GoC, it was widely assumed that property values between the two sides of the island would converge towards the prices prevailing for real estate to the south of the Green Line. Accordingly, real estate became an especially popular investment. Land speculation was further abetted by strong demand from British residents looking for a sunny holiday or retirement home and feeling flush from rapid property appreciation in the British Isles. Between 2003 and 2006, the 65 or so established construction companies in the "TRNC" were joined by another 780 newcomers anxious to quickly buy land, build and sell. The number of real estate agents reportedly increased from 22 in 2001 to over 300 currently.

¶4. (SBU) Even though the Annan Plan failed in the referendum vote of April, 2004, economic growth in the "TRNC" actually

increased -- GDP grew 14.2 percent that year vs. 10.6 percent in 2003. There are various theories to explain this including: a) the belief that the international community would "reward" Turkish Cypriots for voting in favor of the Plan - the UN report in the aftermath of the referendum actually called for ending the area's "political and economic isolation;" b) the uncertainty of the effects of the plan, especially regarding which land would be returned to Greek Cypriots, was removed; c) despite the referendum's failure, increased economic activity was anticipated due to a new agreement allowing people and goods to cross the Green Line.

Finance 101

15. (SBU) Builders of all sizes often tried to finance construction by selling homes "off -plan;" receiving a down-payment and then a series of progress payments as construction proceeded with final payment upon delivery to the buyer. This was especially popular with foreign buyers who reportedly have purchased 50 percent of all the new homes built since 2004. Real estate in the "TRNC" is denominated in British Pounds - a result of the historic volatility of the Turkish Lira and the high rate of interest; 20 percent with a 5-10 year amortization period. Local Sterling loans currently are 8.5-9.5 percent with 4-5 year payback at 70 percent loan to value. Given these terms, few home buyers choose to borrow from banks to finance their home purchase. The poorly developed mortgage market led the larger construction companies to offer financing to buyers--typically loans with a maximum 10-year amortization period, denominated in Sterling.

16. (C) Banking sector exposure to the property market is

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primarily from lending to construction companies. The availability and price of construction financing varies widely according to the size and influence of the builder. Until recently, large and well-established firms were able to receive construction financing for up to 30 percent of the value of the underlying land being developed. Smaller builders have had to depend on bank overdraft facilities, at a rate of 35-40 percent compounded quarterly, and financing from suppliers. If the land in question is not of clearly Turkish-Cypriot title (i.e., land that was in Greek-Cypriots hands until 1974, and then ended-up in the hands of a Turkish-Cypriot), "TRNC" banks would not accept the land as collateral. Only about 20 percent of all land in the "TRNC" enjoys clear Turkish-Cypriot title. The conclusion analysts draw from this, given the lack of sectoral lending detail in "Central Bank" data, is that banks are only moderately exposed to the real estate sector, except to the very largest construction companies.

Post-Dated Checks - Write Your Own Loan

17. (SBU) Many construction companies turned to the use of post-dated checks as a form of financing. This has been a long-standing financing option for individuals and businesses in Cyprus, and there reportedly remains a secondary market for these checks in which dealers buy lots of post-dated checks at a discount and even occasionally sell them on to banks. It should be noted that writing a check without sufficient covering funds is illegal in the "TRNC." So long as real estate kept appreciating and buyers were relatively plentiful, financing in its various forms continued to flow to the sector.

The Air Goes Out

18. (SBU) The bubble began deflating in December, 2006 when the European Court of Human Rights found a Greek-Cypriot's rights were violated by not receiving financial benefit from

land she owned in the north prior to 1974. The GoC widely publicized the legal risks prospective British buyers of property in the "TRNC" would face. Also, British homeowners in the "TRNC" formed pressure groups to publicize their complaints about not receiving what they thought they had purchased from developers as well as shoddy workmanship, lack of a water and/or electrical connection, and trouble receiving title certificates. All this has led to a drastic fall-off in foreign property purchases. The result can be found in the area of Kyrenia (one of the most active construction areas), where 4700 new houses have started construction since 2004, of which 60 percent remain under construction, 27 percent are completed and occupied, and 13 percent are completed and unsold. The large percentage of incomplete or unsold houses means that the post-dated checks that likely financed much of this construction are now due and have no cash inflow to back them up. The head of the Contractors Association told us that financing in the sector is all but impossible to find (including credit from vendors), contractors are going out of business, and home prices are falling.

19. (C) The scramble for cash to cover debts and tightened lending practices have led to a widespread liquidity shortage. This has been exacerbated by the "government's" own liquidity problems--the likely result of tax receipts lower than anticipated and lack of fiscal restraint. Reportedly, the current regime has added many public sector jobs over the last year as a form of patronage and is now delaying infrastructure projects (paid for with Turkish aid funding) to finance current expenditures. The "government" also embarked on a program to reduce Turkish Cypriot shopping in the RoC--both as a means to aid "TRNC" shopkeepers and to help the government collect more VAT income.

10 (C) Comment: In most countries, a quick change from boom to recession, a cash-crunch and misappropriation of donor funds would all spell serious economic trouble. In the "TRNC," however, normal economic rules do not apply. More than 50 percent of the workforce is employed by the public sector and, protected by strong unions and long practice, no one suffers a reduction in salary much less gets laid-off. Most of the workforce in the construction sector are Turkish mainlanders working in the "TRNC" on six-month renewable visas. These migrants are the ones being laid off by contractors, with most Turkish-Cypriots remaining employed. The biggest stabilizing factor, however, is that there is no real cost to the "government's" fiscal ill-discipline. As reflected in the current budget, Turkey comes to the rescue

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with loans and grants equivalent to more than 25 percent of the 2008 budget plus a promise to fund more than half of the anticipated deficit (equivalent to 15 percent of the total budget). Septel will examine the "TRNC" 2008 budget, but it is clear that the "government" has confidence that it will be able to stimulate the economy at will using Turkish funding. The downside to this is that this results in continued poor economic planning and decision-making. This habitual lack of fiscal discipline also has important implications in the politics of the Cyprus problem, as it increases further Ankara's tight grip on Turkish-Cypriot decision-makers, and takes the "TRNC" even farther away from the compliance with the EU *acquis communautaire* which would extend over a reunified Cyprus.

SCHLICHER